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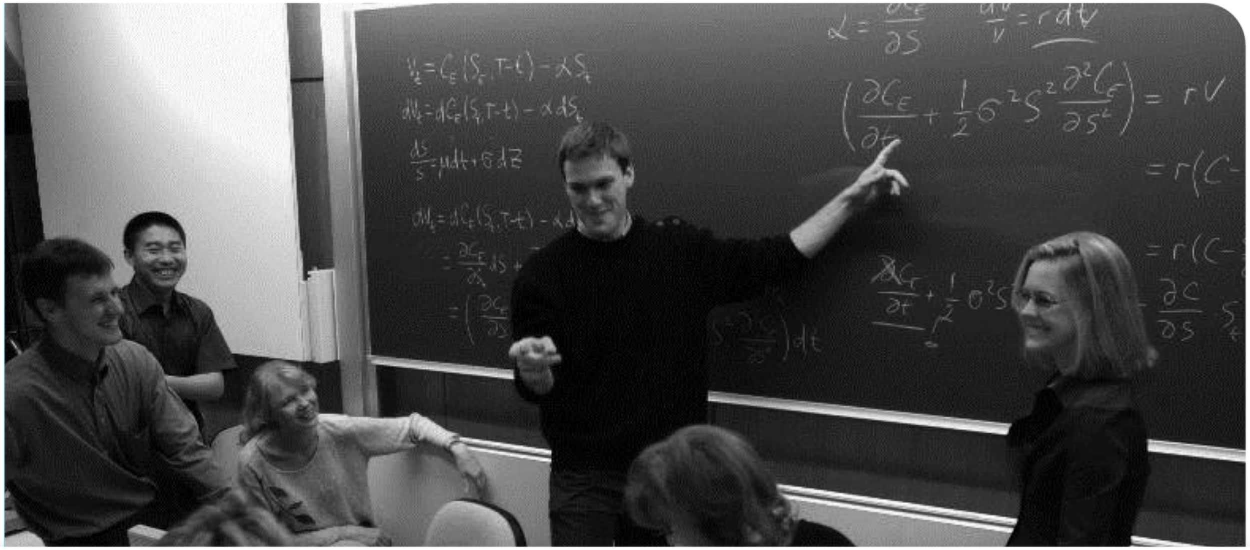

Anette Mikes

From belief systems to risk cultures

- and their role in business models

| le savoir vivant |

LSE, 14 April 2016

The hold of "culture" over management scholarship

- "*The concept of culture is most useful if it helps to explain some of the most seemingly incomprehensible and irrational aspects of groups and organizations*." (Schein, 1993:375)
- "*Risk culture is not separate kind of thing to culture in general. […] Semantics aside there is no doubt that a risk culture industry has been generated in recent years*..." (Power et al., 2013)

Is culture the culprit?

- *“When organizations get into trouble, fixing the culture is usually the prescription.”*
- *But… culture isn’t something you fix. Rather, cultural change is what you get after you’ve put new processes or structures in place…”*

\- Jay Lorsch, HBR2016

Conceptions of culture in management

- *“Culture eats strategy for breakfast.”*

- Phrase attributed to Peter Drucker and made famous by Mark Fields, President at Ford

- *“The thing I have learned at IBM is that culture is everything.”*

– Louis V. Gerstner, Jr. former CEO IBM

Culture – a multi-layered concept

Anthropologists

- Customs and rituals that societies develop over the course of their history.

Organizational scholars, managers

- The *shared* assumptions, learning, behaviours and practices that organizations develop and *stabilize* over time.

AND:

- The espoused *values* and credo of an organization that guide its actions.

- Schein, 1993

- Develop the "right kind of culture"; develop a "culture of quality"; develop "risk culture"
- There are better / worse cultures; stronger / weaker cultures, etc.
- Culture influences organizational effectiveness.

Schein argued "that we must avoid the superficial models of culture and build on the deeper, more complex anthropological models."

Culture – a borrowed concept in management

Anthropologists

- **A group *is* a culture**: culture is a process, pervasive to the group.
- No concern for the culture-performance relationship.
- No culture is "better" than another.

Management scholars

- **A group *has* a culture**: Culture is a manageable entity with performance consequences
- "*Managerial work can be viewed as managing myths, images, symbols and labels*" (Weick, 1979)
- Peters and Waterman (1982) *In Search of Excellence:* culture ought to be managed.
- Schein (1993): "*One of the most decisive functions of leadership is the creation, the management, and sometimes even the destruction of culture. […] Leaders create and change cultures, while managers and administrators live within them.*"

Changing culture is hard to do...

- Intervention 1: to improve listening, communication, conflict management: *"No matter what kind of intervention I attempted, the group's basic style remained the same."*
- Intervention 2 to facilitate innovation via lateral communication: *"No matter what I did, I could not seem to get information flowing, especially laterally across divisional, functional, or geographical boundaries."*

  - Schein, 1993

- Reason: consultant's failure to understand the group's ***shared assumptions and their accumulated shared learning*** (that differed from his) -> *cultural analysis*

Culture evolves to be "coherent" (or not)

- "*A group has a culture when it has had enough of a shared history to have formed a set of shared assumptions*." (Schein, 1993)
- "*Culture implies that rituals, climate, values and behaviors bind together into a coherent whole. [...] Culture formation is [...] a striving toward patterning and integration*." (ibid.)
- Culture is a moving target – and hard to change.

Culture implicated in management accounting research

- Jeremy Dent’s classic study (AOS 1991)
- Bob Simons’ canon (Simons, 1991 - 2005)
- Focus on: business-model change / implementation
- When business models change, cultures change too
- Certain strategies require certain cultures

Culture changed – of Railways and Accountants

- Dent, 1991. Context: business model change at "Eurorail"
- "Business" culture versus "railway culture"
- Series of contests, won by accountants
- Dominant frame of looking at (or ignoring) things: emerges over time and becomes accounting
- Culture here is both a management object (it has been changed) and a manifestation (the organization is a culture).

Caveat emptor:

- c.f. Lorsch and McTague, 2016: *"Culture isn't a final destination. It morphs right along with the company's competitive environment and objectives. It's really more of a temporary landing place…"*

Culture – manageable by accountants/controllers

"Organizational behavior and social psychologists […] take culture as given and immutable, as did Peter Drucker ("culture eats strategy for lunch") because they do not understand or control the levers of management control processes and measurements that we – as accounting scholars – can design and implement in organizations ***to create a new culture for a new strategy****."*

"On culture, […] - you can change a culture with strong leadership, processes, and measurements. This is the fundamental story behind the success of the Kaplan-Norton strategy execution system based on strategy maps, scorecards, and linked management processes."

(Bob Kaplan, via email, 1 April 2016)

- Simons, 1991: belief systems and boundary systems – they are the "control levers" of shaping culture (**in order to implement strategies**).
- Simons, 2005: levers of organization design: cultural elements will be the outcome of certain structures, processes and metrics that managers have to design (**in order to implement strategies**).

Culture controlled – Belief systems

- "A belief system is *the explicit set of organizational definitions* that *senior managers communicate formally* and *reinforce systematically to provide basic values, purpose, and direction for the organization*." (Simons, 1995:34)
- Credos, mission statements, and statements of purpose
- *Core values*
- "…so that middle managers can translate those *beliefs* into *actions* and strategies."
- That transformation happens due to the *commitment* that organizational actors have.
- Incentives do not create commitment – inspirational and value-laden belief systems do.

"Culture is what people do when no-one is watching."

- Gerard Seijts, Ivey Business School

The demise of belief systems…

Case 1:10-cv-03461-PAC Document 42 Filed 03/25/11 Page 1 of 13

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DATE FILED: March 25, 2011

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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ILENE RICHMAN, Individually and on Behalf of All Others Similarly Situated, : 10 Civ. 03461 (PAC)

Plaintiff, : ECF Case

vs. :

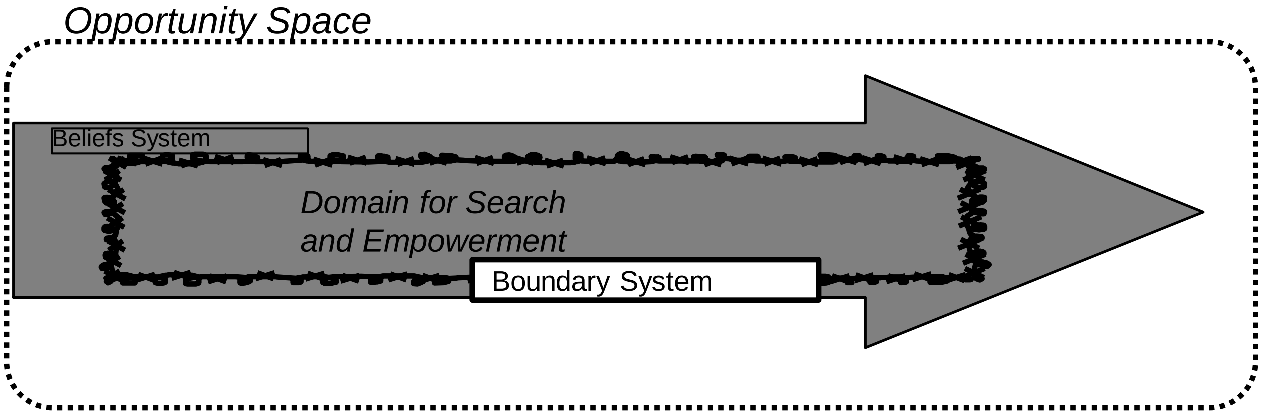
GOLDMAN SACHS GROUP, INC., et al., :

Defendants. :

- Lawyers on behalf of Goldman claimed that these statements were mere *puffery*. Specifically, they argued that "*the vast majority of the supposed 'misstatements' alleged in the complaint—e.g., regarding the firm's 'integrity' and 'honesty'—are nothing more than classic 'puffery' or statements of opinion*."
- Judge Paul Crotty responded in his opinion (June 21, 2012): *"Goldman's arguments in this respect are Orwellian. […] If Goldman's claim of "honesty" and "integrity" are simple puffery, the world of finance may be in more trouble than we recognize."*

Culture controlled – Boundary systems

- "*Boundary systems delineate the acceptable domain of activity for organizational participants. Unlike belief systems, boundary systems do not specify positive ideals. Instead, they establish limits*..." (Simons, 1995: 39)
- The power of negative thinking
  - Business conduct boundaries (overlap with belief systems)
  - Strategic boundaries



The demise of boundary systems…

- Individual transgressions (rogue traders)
- Professional / network-based transgressions (rate-rigging traders)
- Man-made disasters: reveal organizational biases towards the normalization of deviance

Jerome Kerviel, Soc Gen

Kweku Adoboli, UBS

Tom Hayes, UBS and Citigroup

Reflection, questions

- In the financial crisis, *inter alia*, belief systems failed.
- In the LIBOR and other rogue-trader scandals – boundary systems failed (also).
- There are reactive calls for the fixing of **risk cultures.**

"*The point is, you're greedy, you want every little bit of money you can possibly get, because that's how you're judged.*"

"I probably deserve to be sitting here, I made concerted efforts to influence Libor, although I was operating within a system." – Tom Hayes

- **Was risk culture the culprit?**
- **What is risk culture?**

Turning risk culture into a management object…

- Normative beliefs about culture as management object are now widespread
- BP Deepwater Horizon – safety "culture" failed
- Financial Crisis 2007-9– risk "culture" failed
- Assumption: culture has consequences, and could / should be managed "better".
- But the managerialization of risk (culture) in general is problematic
  - C.f. Power, AOS2013: The apparatus of fraud risk
  - Power et al., 2013 (interim report) and 2015 (WP): Searching for risk culture

Risk culture - defined

1. Shared assumptions, attitudes, practices, and values **concerning risks and risk management.**
   - *I argue that this is about the organizational significance of risk management – and from an accounting point of view, a more familiar and "manageable" concern.*
   - *Sociologically speaking, the focus is on risk objects …*
   - *…**related to a given business model***

2. Shared assumptions, attitudes and practices, **concerning the trade-offs among an organization's pluralistic values and objectives**.

   - I argue that in this sense, we must speak of risk cultures as dealing with "values at risk."
   - *Sociologically speaking, the focus is on objects at risk…*
   - ***Not only "strategy at risk", but "values at risk too."***

Risk culture, Part 1:

TAKING RISKS, AND RISK MANAGEMENT, SERIOUSLY

Risk culture

- *"… is a culture where the organization takes risks seriously – it's as simple as that. […] If the chief risk officer doesn't seem to be taken seriously, or is not of the right caliber or is not at the important meetings, these are just little signs that maybe not all is well with the risk culture."* *– Power: What Matters (interview)*

http://youtu.be/Pra_15v1cRg

Taking risks seriously: helps or hinders enterprise?

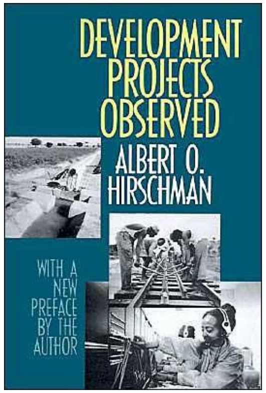
Hinders…

Helps…

JUST DO IT.

The Principle of the Hiding Hand

- Not knowing the risks: “***can serve as a stimulus to enterprise***” by encouraging otherwise risk-averse managers to take on risky projects that in the bright light of thorough risk assessment would appear infeasible.



The Hiding Hand ill-used – in business recently and today

- Risk managers are…
  - The "business prevention department"
  - "Business depressants"
  - The "nerds in the corner"…
- Pre-2007: reckless risk-taking in banking
  - *"Stanley O'Neal, CEO at Merrill Lynch, and Charles Prince, CEO at Citigroup, pushed their divisions to take on more risk to avoid being left behind in the race for trading profits…" (Nocera, NYT, 2008)*

The Hiding Hand ill-used (cont.')

A different view from NASA(JPL)

“At the start of a project, try to write down everything you can that is risky. Then put together a plan for each of those risks, and watch how the plan evolves.”

“JPL engineers graduate from top schools at the top of their class. They are used to being right in their design and engineering decisions. I have to get them comfortable thinking about all the things that can go wrong.”

Gentry Lee – Chief Systems Engineer, JPL

Reconciling the two views

Context appropriate for the Hiding Hand

- *"Underdeveloped countries where confidence in creativity is lacking."*
- *"Where new tasks harboring many unknowns must be presented as though they were all "cut and dried" in order to be undertaken."*

Context not appropriate for the Hiding Hand

- *"In developed countries less hiding of the uncertainties and likely difficulties of a prospective task is required than in underdeveloped countries"*

Quotes are from Hirschman, 1967

The Principle of the Revealing Hand

- Risk culture in action:

"We argue that corporate risk practices should be guided not by the Hiding Hand, but by a countervailing principle that we call the 'Revealing Hand'."

-Kaplan and Mikes (2016): Risk Management: The Revealing Hand

Why the Revealing Hand?

- When managers are systematically overconfident about their strategies and projects, early identification and discussion of risks are required…
- Still, risk management is hard to do… (why?)

Why is risk management so difficult?

"Risk mitigation is painful;

not a natural event for humans to perform."

Gentry Lee – Chief Systems Engineer

Biases in thinking about risks

Strong individual biases against "slow thinking" about risk, bias towards "thinking fast":

- (Over)confidence
- Availability
- Confirmation
- Anchoring

Also, organizational biases:

- Groupthink
- Escalation of commitment
- Normalization of deviance

Effective risk-management processes must counteract those biases

System 1 (fast) versus system 2 (slow) thinking:

Tendency of individuals to use System 1 thinking, which is driven by instinct, emotion, and extensive practice as opposed to System 2 thinking, which is deliberate, analytical, and based on evidence (Kahneman, 2011).

The Revealing Hand of Risk Management

- Revealing Hand requires intrusive, interactive, and inquisitive processes to:

  (1) challenge existing assumptions about the world within and outside the organization;

  (2) communicate risk information, aided by tools such as risk maps, stress tests, and scenarios;

  (3) draw attention to and help close gaps in the control of risks that other control functions (such as internal audit and other boundary controls) leave unaddressed,
  (4) thereby, complementing—without displacing—existing management control practices.

- **Risk culture**: where the Revealing Hand of risk management enables individuals to activate “System 2” careful thinking about risks.

Exploring the Revealing Hand of risk management

What we know

- Most policymakers, regulators, and agree that greater internal clarity about and public disclosure of material risks are likely to lead to better decision-making…

What we need to learn

- …Still, this is an empirical question.
- There is less agreement about how the Revealing Hand of risk management should go about its assignment:
  - Reliability of quantitative risk assessments?
  - What to do about non-measurable risks?
  - Black swans?
  - What issues to cover or leave aside?

Challenges to the Revealing Hand

- Managerial attention and resource allocation - at “good times”?
- The problem of action-generation in the recovery window (Edmondson et al., 2005)
- The problem of inaction
- The pluralism of risk perceptions

Risk culture, Part 2:

A PLURALISTIC PHENOMENON, IMPLYING "VALUES AT RISK"

Risk cultures – example

Feedback and reward	Risk	Low	High
	Rapid	**Work-hard, play-hard culture**	**Tough-guy macho culture**
	Slow	**Process culture**	**Bet-the-company culture**

Terrence E. Deal, Allan A. Kennedy, *Corporate Cultures*, Perseus, 2000

Risk cultures

	Risk	
Feedback and reward	Low	High
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Work-hard, play-hard culture

Stress coming from quantity of work rather than uncertainty.
High-speed action earns rapid feedback and reward.

Tough-guy macho culture

Stress coming from high risk and potential loss/gain of reward.
Focus on the present rather than the longer-term future.

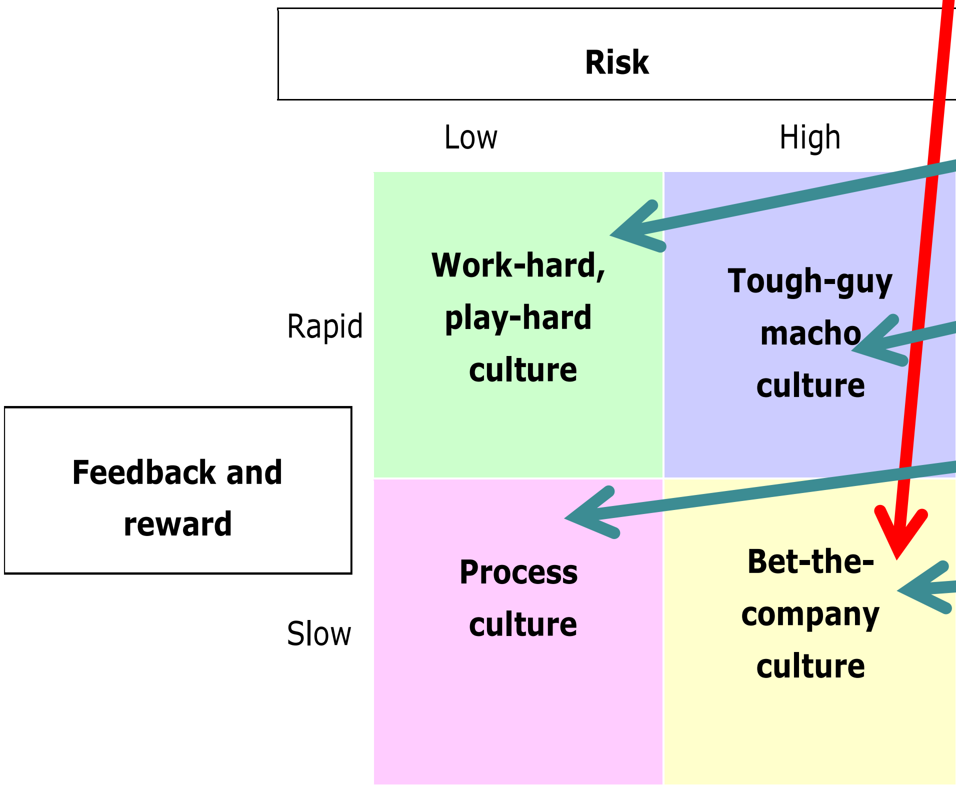
Process culture

Low stress, plodding work, relative security.
Stress may come from internal politics and rigidities.
Focus on security of the past and of the future.

Bet-the-company culture

Stress coming from high risk and delay before knowing if actions have paid off.
The long view is taken, but then much work is needed to make sure things happen as planned.

Risk cultures: JPL? Hydro One?



In Hydro One, it depends where you look:

1. Operations control centre
2. Line repair workers (restoration crews)
3. Billing center
4. Investment and asset management

Terrence E. Deal, Allan A. Kennedy, *Corporate Cultures*, Perseus, 2000

Organizations with risk cultures

- Different people / units hold different perceptions of risk
- Boholm and Corvellec (2011): The relational theory of risk. Sources of disagreements about “risk”:
    1. What is at risk? (*Object at risk*)
    2. What threatens it? (*Risk object*)
    3. What’s the cause-effect relationship between *risk object* and *object at risk*?
- It is hard to develop an integrated “risk culture” in Schein’s sense.
- *One should expect the presence of many “risk culture subgroups” – ambiguity and conflict.*

Risk Culture defined by Risk Appetizing

- Risk appetizing: extending the Revealing Hand principle to "what is at risk" –
- But the concern of risk management now includes **"values at risk", not just "strategy at risk"**
- Risk appetizing assumes three (interrelated) considerations:

  1. Clarity and/or ongoing negotiation about the firm's objectives, values, and priorities;

  2. Every risk decision is a moral decision

  3. Continuous monitoring and benchmarking of a company's risk-taking behavior against its espoused risk appetite.

Weick (1998): Organizations are defined by what risks they leave unattended, and what risks get immediate attention and action.

Core-value-based risk-taking

Case: Merck and Vioxx (Simons, 2009; 2010)

"Core-value-based" risk- taking:

- Makes decision-makers aware of the potential conflicts of interests and moral dilemmas in most difficult decisions and actions;
- Gives decision-makers confidence to defend those decisions and actions.

Core-value-based risk-taking

Makes decision-makers aware of the potential conflicts of interests and moral dilemmas in most difficult decisions and actions;

Gives decision-makers confidence to defend those decisions and actions.

How to operationalize this?

Risk management is emerging as a vehicle for business ethics… (Power et al., 2013)

Source: Rob Quail: Defining your taste for Risk, *Corporate Risk Canada*, 2012

No Service 10:34 90%

quail risk appetite 2012.pdf

Figure 1

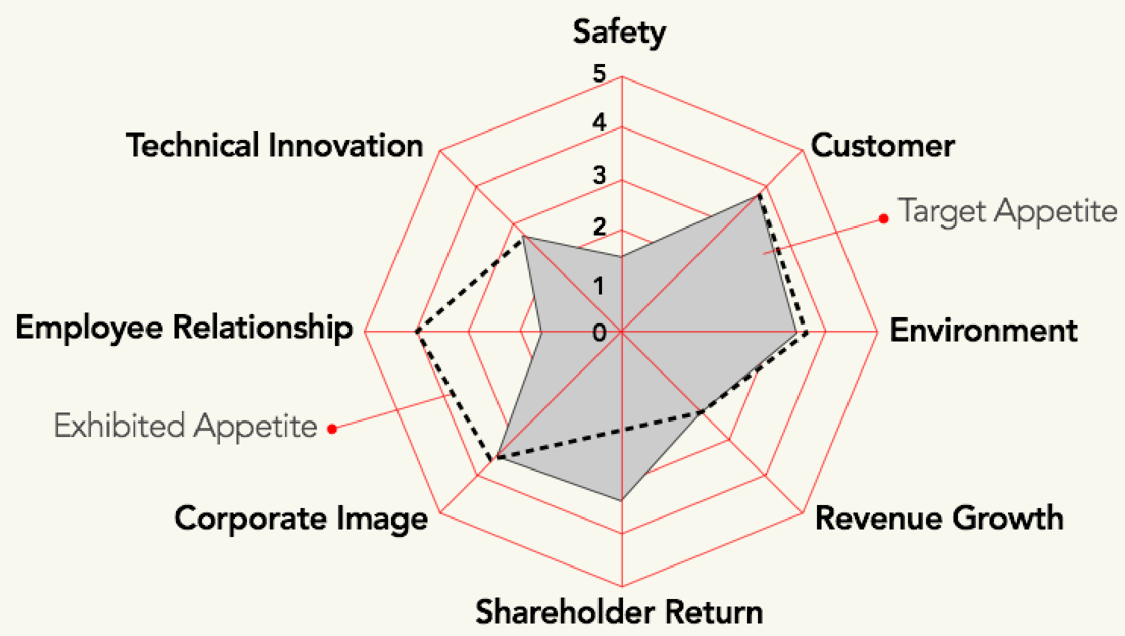
RISK APPETITE SCALE

	Rating	Philosophy	Tolerance for Uncertainty	Choice	Trade-off
		Overall risk-taking philosophy	Willingness to accept uncertain outcomes or period-to-period variation	When faced with multiple options, willingness to select an option that puts objectives at risk	Willingness to trade off against achievement of other objectives
5	**Open**	Will take justified risks	Fully anticipated	Will choose option with highest return; accept possibility of failure	Willing
4	**Flexible**	Will take strongly justified risks	Expect some	Will choose to put at risk, but will manage impact	Willing under right conditions
3	**Cautious**	Preference for safe delivery	Limited	Will accept if limited, and heavily out-weighed by benefits	Prefer to avoid
2	**Minimalist**	Extremely conservative	Low	Will accept only if essential, and limited possibility/extent of failure	With extreme reluctance
1	**Averse**	"Sacred" Avoidance of risk is a core objective	Extremely low	Will select the lowest risk option, always	Never

Source: Rob Quail: Defining your taste for Risk, *Corporate Risk Canada*, 2012

Figure 3

TARGET VS. EXHIBITED RISK APPETITE



Source: Rob Quail: Defining your taste for Risk, *Corporate Risk Canada*, 2012

Developing risk culture via risk appetizing

- The ongoing monitoring and discussion of risk appetite is of key importance
- It requires trade-offs to be made all the time (due to conflicting priorities, objectives, stakeholders and values **implicated by business models**)
- Prioritization of objectives will (must) change over time (**as do business models do**)

Managerializing risk culture

- Once created, categories will harden through repetition, institutionalization and instrumentalization. (Power, 2013)
- Demands to extend SOMEONE's role to include ever more risk objects
  - Auditors
  - Risk managers
  - Non-executive directors…
- Risk culture is still being fought over, and the search for its "manageable categories" is ongoing.
- In summary, it (could) includes:
  - Incentive systems and multiple trade-offs (Power et al., 2013)
  - Trade-offs ingrained in professional practice (Dent, 1991)
  - Core values (Simons, 1991)
  - Risk appetite (Kaplan and Mikes, 2016)

Concluding remarks on banks…

Key questions in Financial Services:

- How to change business models in order to adapt to changing economic, regulatory and cultural environments and stakeholder demands?
- What’s the role of different types of banking in society?
- Depending on the answers, risk cultures will follow.

Questions?

THANK YOU.